The leasing standard
A comprehensive look at the new model and its impact

Insurance industry supplement

At a glance
Earlier this year, the FASB issued its long-awaited and much anticipated standard on leasing. Under the new guidance, lessees will be required to bring substantially all leases onto their balance sheets. This and other provisions will likely introduce some level of change for all entities that are party to a lease.

In depth US2016-02 provides an analysis of the new standard. This supplement highlights some of the areas that could create the most significant challenges for entities in the insurance sector as they transition to the new standard.

In addition, PwC’s accounting guide, Leases – 2016 edition, was released in April 2016 and contains a comprehensive overview of the new leasing standard and its related impacts.

Overview
Entities in the insurance sector are generally lessees and, at times, lessors of assets. Lease accounting literature and related interpretations under US GAAP has sometimes presented challenges for lessees, and can result in different financial reporting outcomes for economically similar transactions based solely on the nuanced terms of particular leasing transactions. The FASB’s new standard, Leases (ASC 842), represents the first comprehensive overhaul of lease accounting since FAS 13 was issued in 1976. The FASB’s objectives for the new standard were increased transparency and comparability across organizations.

ASC 842 requires lessees to capitalize all leases with a term of more than one year. A lessee’s income statement recognition of lease-related expense will depend on the lease’s classification as either an operating or financing lease. See the Lessee Accounting Model described on page 5 for more information.

For income statement purposes, a lessee in an operating lease will continue to record lease expense—typically on a straight-line basis. Finance leases will result in a front-loaded expense pattern (similar to today’s capital leases). Although the pattern of expense recognition may be similar to today’s accounting, the amount of lease expense recorded could differ due to changes in how certain elements of rent payments are treated.

Lessors will classify leases as operating, direct financing, or sales-type based on criteria similar to that used by lessees, plus an additional requirement to assess collectibility of lease payments.
**Effective date and transition**

The new standard is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For calendar year-end public business entities, this means an adoption date of January 1, 2019.

For other entities (i.e., those not meeting the FASB’s definition of a public business entity), the new standard is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

Early adoption is permitted for all entities. The new standard is required to be adopted using a modified retrospective approach, which means application of the new guidance at the beginning of the earliest comparative period presented in the year of adoption. For other calendar year-end entities adopting the standard on January 1, 2019, this means retrospective application to annual and interim financial statements for 2018 and 2017. For calendar year-end companies, other than public business entities, adopting the standard on January 1, 2020, this means retrospective application to annual financial statements for 2018 and 2019 if comparative statements for two preceding years are presented. To reduce some of the burden of adoption, there are certain practical expedients, some of which are required to be adopted together.

**Impact**

As insurance entities are generally the lessee in the majority of their lease arrangements, they will primarily be impacted by the changes to the lessee accounting model. Insurance companies will need to analyze how the new model will affect systems, data requirements, and business processes and controls.

**Statutory capital considerations**

Statutory capital requirements for insurance entities are based on statutory accounting and not US GAAP. Current statutory accounting treats all leases as operating leases. In 2016, the National Association of Insurance Commissioners began discussing whether statutory accounting should be amended as a result of the FASB’s new leasing guidance. Any changes to statutory capital requirements for leases would likely occur after a decision is made regarding the statutory accounting.

For those entities subject to Federal capital requirements based on US GAAP, the new standard may have capital implications.
Embedded leases

An entity is required to first determine if an arrangement is or contains a lease. The concept of leases embedded in other contracts is not new. However, under current lessee guidance, embedded leases are often off-balance sheet operating leases and, as such, application of lease accounting may not have had a material impact on the income statement. Determining whether to apply lease accounting to an arrangement under the new guidance is likely to be far more important since most leases will result in recognition of a right-of-use asset and lease liability.

Under the new guidance, an arrangement is or will contain a lease if an underlying asset is explicitly or implicitly identified and use of the asset is controlled by the customer.

An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct, but one floor within the building may also be considered physically distinct if it can be used independent of the other floors (e.g., point of entry or exit, access to lavatories).

A customer controls the use of the identified asset by possessing the right to (1) obtain substantially all of the economic benefits from the use of such asset (“economics” criterion); and (2) direct the use of the identified asset throughout the period of use (“power” criterion). A customer meets the “power” criterion if it holds the right to make decisions that have the most significant impact on the economic benefits derived from the use of the asset. If these decisions are pre-determined in the contract, then the customer must have the right to direct the operations of the asset without the supplier having the right to change those operating instructions throughout the period of use for the contract to be a lease.

The new model differs in certain respects from today’s risks and rewards model and may result in the identification of fewer embedded leases compared to current guidance.

PwC observation:

There has been a trend in the financial services sectors in recent years to formally outsource business operations and support functions—in some cases on a global scale—to leverage and drive expertise. Insurance companies will need to assess their contractual arrangements to determine if they contain an embedded lease. Common examples of arrangements that might contain an embedded lease are outsourced technology operations and datacenter arrangements.

Example 1 – Whether a contract contains a lease: outsourced information technology function

Facts: Insurance Corp (“Customer”) enters into a 3-year IT contract with a service provider (“Supplier”) for IT related services. Under this arrangement, Supplier installs a dedicated server at Customer’s premises to be used by Customer during the term of the arrangement. The server is explicitly identified in the contract and Supplier is permitted to substitute the server only if it malfunctions. Customer decides which data to store on or delete from the server and how to integrate the server within its operations throughout the contract term. Supplier provides maintenance and other support services, such as nightly data back-up and software upgrades.

Question: Does the contract contain a lease?

Discussion: Yes, the contract contains a lease.

The contract explicitly identifies a server that the Supplier can substitute only in the event of malfunction. Therefore, the arrangement contains an identified property, plant, or equipment, i.e., the server.

Customer has the right to control the use of the server because it has (a) the right to obtain the economic benefits from the use of the identified server based on its exclusive access and use of the server during the 3-year term; and (b) the right to direct the use of the identified server because of its ability to determine which data is stored, and the nature and timing of the content place on the server. Maintenance and support activities ensure the server operates as it should but do not impact how and for what purpose the server is used because they do not affect the economic benefits to be derived from the use of the server.
Alternatively, if Customer used a public cloud-based offering from Supplier instead of a dedicated server, the arrangement may not contain an embedded lease. This assumes Supplier has alternate servers and the legal right to manage server capacity to obtain the optimal configuration to service as many customers as possible.

**Components, contract consideration, and allocation**

If an arrangement is a lease or contains an embedded lease, it may contain lease and nonlease components that are subject to different accounting models. Components are those items or activities that transfer a good or service to the lessee. Once the lease and non-lease components are identified, contract consideration is allocated to each component.

Contract consideration consists of consideration attributable to both lease and nonlease components. A lessee should allocate the contract consideration to the separate lease and nonlease components based on their relative standalone prices. As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose to not separate nonlease components from lease components and instead account for a lease component and the associated nonlease component as a single lease component.

Property taxes and insurance would be incurred whether or not an asset is leased or who the lessee might be. Therefore, they are not considered components but instead are considered as part of overall contract consideration to be allocated to lease and nonlease components. Maintenance costs, on the other hand, involve delivery of a separate service and are therefore considered as a nonlease component if provided by the lessor to the lessee.

The impact of property taxes and insurance on measurement of the right-of-use asset and liability depends on how the payments are made. If a company pays the actual amount of property taxes and insurance directly, rather than including these items in the fixed lease payments, they should be accounted for similar to other variable lease payments, i.e., if variable payments are not dependent on an index or a rate, they are excluded from lease payments for classification and initial measurement of the lease liability and right-of-use asset.

**PwC observation:**

The lessee has a practical expedient to account for a lease component and the associated nonlease component as a single lease component. If the practical expedient is elected, the cash flows associated with the nonlease element will increase the liability and right-of-use asset recognized on the balance sheet. This is a policy election by asset class. In deciding whether to elect the practical expedient, companies are likely to consider the significance of the increase to the asset and liability relative to the effort and complexity in getting reliable information to separately account for the lease and nonlease components. Insurance sector lessees with material embedded leases will need additional processes and controls to ensure an appropriate allocation based on relative standalone prices that maximize the use of observable prices (use of the residual method is permitted only in limited circumstances).

**Example 2 – Leases may have more than one component**

**Facts:** Insurance Corp (“Lessee”) rents a building and land from Landlord Corp (“Lessor”) to be used as office space for 15 years. The rental contract stipulates that the building is fully furnished and there is a new HVAC system that was installed by Lessor at Lessor’s cost. Lessee has the option to use a third-party maintenance company for maintaining the building, land and HVAC, but decides to hire Lessor to provide the maintenance service because Lessor offers a discounted price for such service. Lessee makes a gross monthly payment of $3,000 to Lessor (total of $36,000 per year) which includes rent for the building and land, maintenance services, and a fixed amount for property taxes and insurance.

Assume that all lease components are operating leases and Lessee’s incremental borrowing rate is 5%.

**Question 1:** What are the components in the arrangement?

**Discussion:** The arrangement contains two lease components - “Building” (building, HVAC, land) and office furniture - and one nonlease component - maintenance services.

The building and HVAC are considered one lease component because they are highly inter-related and cannot function independent of each other. The new standard requires Lessee to account for the right to use land as a separate lease...
component unless the accounting effect of doing so would be insignificant, i.e., separating the land component would not affect the lease classification of the other lease components or the amount recognized for the land lease component would be insignificant. In this example, Lessee concludes that the land component is not a separate lease component.

Office furniture is considered a separate lease component as it is neither dependent on, nor highly interrelated with the Building component because it could be sourced from other providers or be used in other office buildings. Accordingly, the right to use the office furniture is a separate lease component.

Maintenance for Building is a separate service provided to Lessee and is therefore considered a separate nonlease component. Assume Lessee does not apply the practical expedient and accounts for the maintenance services as a separate component.

**Question 2: How should the contract consideration be allocated by Lessee?**

**Discussion:** Contract consideration is $540,000 ($36,000 per year x 15 years). In order to allocate contract consideration to the components, the standard requires Lessee to determine the standalone prices of each of the components. Any discount embedded in the arrangement is allocated among all the components identified in the arrangement based on the relative standalone prices of the components. Based on the assumed observable market data supporting the standalone prices below, Lessee would allocate the total consideration as follows.

<table>
<thead>
<tr>
<th></th>
<th>Standalone price (A)</th>
<th>Allocation % (A/$549,000) = (B)</th>
<th>Allocation of contract consideration (B*$540,000) = (D)</th>
<th>Allocated annual amount (D/15)=E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building lease</td>
<td>$360,000</td>
<td>66%</td>
<td>$356,400</td>
<td>$23,760</td>
</tr>
<tr>
<td>Office furniture lease</td>
<td>90,000</td>
<td>16%</td>
<td>86,400</td>
<td>5,760</td>
</tr>
<tr>
<td>Maintenance services</td>
<td>99,000*</td>
<td>18%</td>
<td>97,200</td>
<td>6,480</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$549,000</strong></td>
<td><strong>100%</strong></td>
<td><strong>$540,000</strong></td>
<td><strong>$36,000</strong></td>
</tr>
</tbody>
</table>

* Even though Lessor offered the maintenance services to Lessee at a discount, the standalone price for maintenance services should be used for allocation purposes.

In this example, Lessee would record a total lease liability equal to $321,599, which is the present value of 15 annual payments of $29,508 ($23,760+$5,760) discounted at 5%. The right-of-use asset would be equal to the lease liability in this example ($321,599). If Lessee elected not to separately account for the maintenance services, it would recognize a total lease liability and a total right-of-use asset equal to $392,351 (present value of 15 payments of $36,000 discounted at 5%). As Lessee has elected to treat maintenance as a separate nonlease component, the allocated cost should be expensed as incurred.

**Lessee accounting model**

Once an entity determines the lease and nonlease components in an arrangement that is or contains a lease, the entity should then classify the lease components.

Lessees will be required to recognize a right-of-use asset and lease liability for virtually all leases (other than short-term leases). For income statement purposes, the FASB retained a dual lease model, requiring leases to be classified as either operating or finance leases. Operating leases will typically result in straight-line expense (similar to current operating leases) while finance leases will result in a front-loaded expense pattern (similar to current capital leases). Classification will be based on criteria that are largely similar to those in current lease accounting guidance, but (a) without explicitly stated bright lines and (b) with an additional explicit criterion related to the specialized nature of the leased asset and whether it is expected to have an alternative use to the lessor at the end of the lease term.
Insurance companies often lease their head office and regional centers. The recognition of right-of-use assets and the associated liabilities for these leases will impact the balance sheet. This may affect loan covenants, credit ratings, and other external measures of financial performance.

PwC observation:
The ability to gather the required information on existing leases and capture data at the inception of new leases will be critical to an effective transition to the new standard. This may result in the need for new systems, controls, and processes, which will take time to identify, design, implement, and test.

Example 3 – Lease classification, initial and subsequent measurement

Facts: Insurance Corp enters into a lease of an office building with Lessor Corp. The following is a summary of information about the lease and the leased building.

<table>
<thead>
<tr>
<th>Lease term</th>
<th>5 years with no renewal option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remaining economic life of the building</td>
<td>40 years</td>
</tr>
<tr>
<td>Purchase option</td>
<td>None</td>
</tr>
<tr>
<td>Annual lease payments</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Payment date</td>
<td>Annually in advance on January 1</td>
</tr>
<tr>
<td>Fair value of the building</td>
<td>$50,000,000</td>
</tr>
<tr>
<td>Insurance Corp’s incremental borrowing rate</td>
<td>5%</td>
</tr>
</tbody>
</table>

Other information
- The rate implicit in the lease that Lessor Corp charges Insurance Corp is not readily determinable by Insurance Corp
- Title to the building remains with Lessor Corp throughout the period of the lease and upon lease expiration
- Insurance Corp does not guarantee the residual value of the building
- Insurance Corp pays for all property taxes, insurance, and maintenance of the building separate from lease payments (i.e., a triple net lease)
- Lessor Corp reimburses Insurance Corp $100,000 at the lease commencement date for moving expenses as a lease incentive
- The lease commencement date does not fall at or near the end of the economic life of the building

Question 1: How should Insurance Corp classify this lease?

Discussion: Insurance Corp would assess the arrangement using the classification criteria as follows:
- The lease does not transfer ownership of the building to Insurance Corp by the end of the lease term.
- The lease does not grant Insurance Corp an option to purchase the building.
- Insurance Corp would utilize the building for approximately 13% of its remaining economic life (5 year lease / 40 year remaining economic life). This is not considered a major portion of the remaining economic life.
• As the rate implicit in the lease is not readily determinable, Insurance Corp would use its incremental borrowing rate (5%) to calculate the present value of the lease payments. The present value of the $1,100,000 annual lease payments (payable at the beginning of each year) less $100,000 lease incentive paid by Lessor Corp at the lease commencement date is $4,900,545. This represents approximately 10% of the $50,000,000 fair value of the building, which does not amount to substantially all of the fair value of the building.

• The underlying asset is an office building and is not of such a specialized nature that it is expected to have no alternative use to Lessor Corp at the end of the lease term.

Based on the above analysis, the lease is an operating lease.

**Question 2:** How should Insurance Corp account for the lease at lease commencement date?

**Discussion:** Insurance Corp should measure the lease liability by calculating the present value of the unpaid annual fixed lease payments of $1,100,000 discounted at Insurance Corp’s incremental borrowing rate of 5% ($5,000,545). Since Insurance Corp received a $100,000 lease incentive at lease commencement, the right-of-use asset would be equal to the lease liability, reduced by the $100,000 lease incentive received at lease commencement ($4,900,545).

Although not included in the example, the right-of-use asset would be adjusted for any initial direct costs incurred by Insurance Corp or lease payments made to Lessor Corp on or before the commencement date—both of which would increase the right-of-use asset recognized by Insurance Corp.

**Question 3:** How should Insurance Corp subsequently measure the right-of-use asset and lease liability during the lease term?

**Discussion:** Insurance Corp would calculate the total lease cost equal to the $1,100,000 rent payment per year for five years less the $100,000 lease incentive ($5,400,000). The straight-line lease expense recorded each period would be the total lease cost divided by the total number of periods, which is $1,080,000.

Interest on the lease liability would be calculated using a rate of 5%, the same discount rate used to initially measure the lease liability. The lease liability would be amortized as follows (assuming beginning of year payments):

<table>
<thead>
<tr>
<th></th>
<th>Payment</th>
<th>Principal</th>
<th>Interest paid</th>
<th>Interest expense</th>
<th>Lease liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commencement</td>
<td>$1,100,000*</td>
<td>$1,100,000</td>
<td>$</td>
<td>-*</td>
<td>$5,000,545</td>
</tr>
<tr>
<td>Year 1</td>
<td>$1,100,000</td>
<td>904,973</td>
<td>195,027</td>
<td>149,779</td>
<td>3,145,351</td>
</tr>
<tr>
<td>Year 2</td>
<td>1,100,000</td>
<td>950,221</td>
<td>149,779</td>
<td>102,268</td>
<td>2,147,619</td>
</tr>
<tr>
<td>Year 3</td>
<td>1,100,000</td>
<td>997,732</td>
<td>102,268</td>
<td>52,381</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Year 4</td>
<td>1,100,000</td>
<td>1,047,619</td>
<td>52,381</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Year 5</td>
<td>$5,500,000</td>
<td>$5,000,545</td>
<td>$499,455</td>
<td>$499,455</td>
<td>$</td>
</tr>
</tbody>
</table>

* Initial payment was due day 1 of the lease; therefore the entire payment is a reduction of principal.
The amortization of the right-of-use asset is the difference between the straight-line lease expense and interest on the lease liability. The following table shows this calculation.

<table>
<thead>
<tr>
<th></th>
<th>Straight line expense (A)</th>
<th>Interest expense on lease liability (B)</th>
<th>Amortization (A – B)</th>
<th>Right-of-use asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commencement</td>
<td></td>
<td></td>
<td></td>
<td>$4,900,545</td>
</tr>
<tr>
<td>Year 1</td>
<td>$1,080,000</td>
<td>$195,027</td>
<td>$884,973</td>
<td>4,015,572</td>
</tr>
<tr>
<td>Year 2</td>
<td>1,080,000</td>
<td>149,779</td>
<td>930,221</td>
<td>3,085,351</td>
</tr>
<tr>
<td>Year 3</td>
<td>1,080,000</td>
<td>102,268</td>
<td>977,732</td>
<td>2,107,619</td>
</tr>
<tr>
<td>Year 4</td>
<td>1,080,000</td>
<td>52,381</td>
<td>1,027,619</td>
<td>1,080,000</td>
</tr>
<tr>
<td>Year 5</td>
<td>1,080,000</td>
<td>-</td>
<td>1,080,000</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>$5,400,000</td>
<td>$499,455</td>
<td>$4,900,545</td>
<td>$</td>
</tr>
</tbody>
</table>

**Initial direct costs**

Initial direct costs are incremental costs of a lease that would not have been incurred had the lease not been executed. Any costs that would have been incurred even if lease were not executed are not incremental costs and should be excluded from initial direct costs. For example, external legal fees are excluded from initial direct costs assuming the lessee would be required to pay its attorneys for negotiating the lease even if the lease were not executed. However, when a lessee and lessor execute a legally-binding lease commitment prior to drafting the lease agreement, legal fees for drafting may be incremental costs that can be accounted for as initial direct costs.

The definition of initial direct costs has changed under the new leasing standard compared to the definition under today’s guidance. This new definition may not align with similar definitions used in other areas of US GAAP, such as in the deferred acquisition costs guidance applicable to companies in the insurance sector.

**Lease modification (lessee)**

A lease modification is any change to the terms and conditions of a contract that results in a change in the scope of, or the consideration for, use of an underlying asset. A modification is accounted for as a contract separate from the original lease if the modification grants the lessee an additional right of use not included in the original lease and the additional right of use is priced consistent with its standalone value adjusted for the contract’s circumstances. When a modification is a separate lease, the accounting for the original lease is unchanged and the new lease component(s) should be accounted for at commencement like any other new lease. In contrast, when a lease is modified and the modification is not recognized as a separate lease, the lessee must remeasure and reallocate all of the remaining contract consideration from both lease and nonlease components based on the modified contract, reassess classification, remeasure the lease liability, and adjust the right-of-use asset using assumptions as of the effective date of the modification (e.g., updates the discount rate, fair value, and remaining economic life). Any direct costs, lease incentives, or other payments by the lessee or lessor would be accounted for by the lessee similar to the accounting for those items in a new lease.
Example 4 – Accounting for an operating lease that is modified to change lease payments and lease term

Facts: On January 1, 20X1, Insurance Corp enters into a contract with Lessor Corp to lease a building that will be used as office space. The lease has the following terms:

<table>
<thead>
<tr>
<th>Term</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease commencement date</td>
<td>January 1, 20X1</td>
</tr>
<tr>
<td>Lease term</td>
<td>5 years with no renewal option</td>
</tr>
<tr>
<td>Annual lease payments</td>
<td>$100,000</td>
</tr>
<tr>
<td>Payment date</td>
<td>Annually in advance on January 1</td>
</tr>
<tr>
<td>Initial direct costs</td>
<td>$10,000</td>
</tr>
<tr>
<td>Insurance Corp’s incremental borrowing rate</td>
<td>5% (Insurance Corp does not know the rate implicit in the lease)</td>
</tr>
</tbody>
</table>

Insurance Corp determines that the lease is an operating lease at the lease commencement date.

On January 1, 20X4 (beginning of year 4 of the lease), Insurance Corp and Lessor Corp amend the original lease agreement such that the lease contract is extended for an additional three years beyond the current 5-year term and the remaining annual lease payments are reduced to $90,000 to reflect current market rates. The following table summarizes pertinent information as of the lease modification date.

<table>
<thead>
<tr>
<th>Term</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modification date</td>
<td>January 1, 20X4</td>
</tr>
<tr>
<td>Remaining lease term at modification date</td>
<td>5 years</td>
</tr>
<tr>
<td>Annual lease payments (20X4 through 20X8)</td>
<td>$90,000</td>
</tr>
<tr>
<td>Insurance Corp’s incremental borrowing rate on the modification date</td>
<td>4%</td>
</tr>
<tr>
<td>Right-of-use asset immediately before the modification</td>
<td>$199,238</td>
</tr>
<tr>
<td>Lease liability immediately before the modification</td>
<td>$195,238</td>
</tr>
</tbody>
</table>

Insurance Corp determines that the lease modification should not be accounted for as a new lease because an additional right of use was not granted. Insurance Corp reassesses the lease classification and determines that the modified lease is still an operating lease.

Question: How should Insurance Corp account for the lease modification?

Discussion: Insurance Corp should remeasure the lease as of the modification date as shown below.

Balance sheet impact

Insurance Corp should remeasure the lease liability on the date of the modification by calculating the present value of the remaining lease payments for the modified lease term using Insurance Corp’s discount rate of 4%. The modified lease liability is $416,690 as shown in the table below.
To calculate the adjustment to the lease liability, Insurance Corp should compare the recalculated lease liability balance and the original lease liability balance on the modification date. The Lease liability is adjusted as follows:

<table>
<thead>
<tr>
<th>Revised lease liability</th>
<th>$416,690</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original lease liability</td>
<td>$195,238</td>
</tr>
<tr>
<td>Increase in lease liability</td>
<td>$221,452</td>
</tr>
</tbody>
</table>

Right-of-use asset is adjusted as follows:

<table>
<thead>
<tr>
<th>Original right-of-use asset</th>
<th>$199,238</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in lease liability</td>
<td>$221,452</td>
</tr>
<tr>
<td>Revised right-of-use asset</td>
<td>$420,690</td>
</tr>
</tbody>
</table>

**Income statement impact**

Insurance Corp would recalculate the straight-line lease expense using the following formula:

\[
\text{Remaining lease term} = \frac{\text{Future undiscounted cash flows at the remeasurement date} + \left(\text{the right-of-use asset less the lease liability immediately before the remeasurement}\right)}{\text{Remaining lease term}}
\]

For this example, the amounts are as follows:

\[
\frac{450,000 + (199,238 - 195,238)}{5} = 90,800 \text{ single annual lease expense for the remaining term of the lease}
\]
Lease reassessment

There are circumstances when a lessee will be required to assess and potentially remeasure the right-of-use asset and lease liability subsequent to lease commencement even without a lease modification. The table below lists these circumstances and the related impact on the lessee’s accounting.

<table>
<thead>
<tr>
<th></th>
<th>Reallocate contract consideration and remeasure the lease</th>
<th>Reassess classification</th>
<th>Update discount rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>An event occurs that gives the lessee a significant economic incentive to exercise/not exercise a renewal option</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>An event occurs that gives the lessee a significant economic incentive to exercise/not exercise a purchase option</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>A contingency on which variable payments are based is met such that some or all the payments become fixed lease payments</td>
<td></td>
<td>✔</td>
<td></td>
</tr>
<tr>
<td>Amounts due under a residual value guarantee become probable of being owed</td>
<td></td>
<td></td>
<td>✔</td>
</tr>
</tbody>
</table>

Lessors are not subject to these reassessment requirements.

**PwC observation:**

For a reassessment of the lease term or exercise of a purchase option, the triggering event must be within the control of the lessee (if not, the event will not require a reassessment). A change in market-based factors will not, in isolation, trigger a reassessment of the incentive to exercise a renewal option or a purchase option. For example, a reassessment would not be triggered if a lessee is leasing office space and current market conditions for the office space location change such that lease payments that the lessee will be required to make in the extension period are now considered below market. It will be important for a company to ensure it has processes and controls in place to identify and monitor triggering events that would require the reassessment of a lease.

Sale-leaseback arrangements

Existing sale-leaseback guidance, including for transactions related to real estate, is replaced with a new model applicable to both lessees and lessors. A sale-leaseback transaction will qualify as a sale only if (1) there is a contract and control has transferred per the guidance in the new revenue recognition standard (ASC 606), (2) the leaseback is not a finance lease, and (3) a repurchase option, if any, is exercisable at a price that is the asset’s fair value at the time of exercise and a substantially similar alternative asset is readily available in the marketplace. When these conditions are met, control has passed to the buyer-lessee and the buyer-lessee should recognize a purchase. The seller-lessee should derecognize the underlying asset and recognize a gain or loss on sale as appropriate. Recognition of a gain (adjusted for off-market terms) immediately upon the recognition of the sale and leaseback transaction is a change from today’s guidance when typically, the gain is deferred and recognized over the lease term.

If the transaction does not qualify as a sale, the seller-lessee would not derecognize the transferred asset and would reflect the proceeds received from the sale-leaseback transaction as a borrowing. The buyer-lessee would reflect its cash payment as a loan.
The five indicators included in the new revenue standard to determine whether a customer has obtained control of an asset are:

- The reporting entity (transferor) has a present right to payment
- The customer has legal title
- The customer has physical possession
- The customer has the significant risks and rewards of ownership
- The customer has accepted the asset

Not all of the indicators need to be met to conclude that control has transferred from seller-lessee to buyer-lessee and the list is not all inclusive. Judgment will be required to determine whether a sale has occurred, and the conclusion will depend on the specific facts and circumstances of the transaction.

In the revenue standard, sale recognition is precluded when the seller-lessee has a substantive right to repurchase the underlying asset (a call option) or an obligation to repurchase the underlying asset (a forward). Sale recognition is also precluded when the seller-lessee has an obligation to repurchase the underlying asset at the buyer-lessee's request at a price that is lower than the original selling price and the buyer-lessee has a significant economic incentive to exercise that right. Despite this prohibition in the revenue guidance, the existence of a repurchase option does not always preclude recognition of a sale-leaseback when the underlying asset is (1) equipment, (2) readily available in the market, and (3) the option is at the then-fair market value.

PwC observation:
Although the existence of a repurchase option does not always preclude sale recognition, it would be unusual when the asset is real estate. Since real estate is unique, it is difficult to envision a scenario when a reporting entity could assert that an alternative real estate asset is substantially the same as the underlying real estate asset.

Example 5 – Sale-leaseback transactions - gain on sale

Facts: Insurance Corp enters into a sale-leaseback transaction of its corporate headquarters with a buyer-lessee for cash of $20 million. The sale price is considered to be fair market value. Insurance Corp, the seller-lessee, leases back a portion of the asset for ten years in exchange for $200,000 per year in rental payments, which is consistent with the market rate absent a leaseback. Insurance Corp has no repurchase option. Insurance Corp is required to give the buyer-lessee a significant security deposit. Insurance Corp's net carrying amount of the asset at the date of sale is $15 million. Assume the leaseback is classified as an operating lease and that the transaction is a sale under the new revenue recognition guidance.

Question: How should Insurance Corp account for the asset sale?

Discussion: Since the sale-leaseback transaction was executed on market terms and the leaseback is classified as an operating lease, Insurance Corp should recognize the gain on sale of $5 million at lease commencement. Under today’s sale-leaseback guidance for real estate, Insurance Corp’s collateral would have been considered a prohibited form of continuing involvement precluding sale-leaseback accounting, resulting in a financing. Even if no prohibited continuing involvement was present, today’s guidance would limit immediate gain recognition to proceeds in excess of the present value of the minimum lease payments unless the leaseback is minor.
Build-to-suit arrangements

When a prospective lessee is involved in the construction or design of an underlying asset prior to lease commencement (commonly referred to as a “build-to-suit” lease), current US GAAP imposes prescriptive qualitative and quantitative rules that often result in the lessee being considered the owner of the asset during construction for accounting purposes. The lessee would also be required to record debt equal to construction funding provided by the landlord to construct the asset.

The new leases standard replaces today’s build-to-suit guidance with a new model under which a lessee is the deemed owner of an asset under construction only if the lessee controls the asset during the construction period. Control can be obtained in a variety of ways. The FASB has provided a list of scenarios in the new guidance that demonstrate when control has transferred. Judgment will be required in assessing control, as the list provided by the FASB is not all-inclusive. The scenarios included in ASC 842 are as follows.

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (for example, by making a payment to the lessor)
- The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor
- The lessee legally owns either (a) both the land and the property improvements that are under construction, or (b) the non-real estate asset that is under construction
- The lessee controls the land that property improvements will be constructed upon and does not lease the land to the lessor (or another unrelated third party) before construction starts for a period (including renewals) that is for substantially all of the economic life of the property improvements
- The lessee is leasing the land that property improvements will be constructed upon for a period (including lessee renewal options) that is for substantially all of the economic life of the property improvements, and does not sublease the land to the lessor (or another unrelated third party) before construction starts for a period (including renewals) that is for substantially all of the economic life of the property

If the lessee controls the asset under construction during the construction period, the sale and leaseback model would apply when control passes from the lessee to the lessor (typically once construction is complete and the lease commences). If the requirements under the sale and leaseback model are not met at commencement, the transaction would be accounted for as a financing by both the lessee and lessor.

If a lessee does not have control of the asset under construction, judgment may be required to determine how to account for costs it incurs during construction. If such costs relate to leasehold improvements, the lessee should generally account for those costs in accordance with ASC 360, *Property, Plant, and Equipment*. Payments made by the lessee for the right to use the asset should be accounted for as lease payments regardless of when the payments occur or the form of such payments. For example, if the lessee pays for (or contributes) construction materials to construct the lessor’s asset, such payments are included in lease payments as prepaid rent.

PwC observation:

Lessees often incur construction costs to customize their leased space. Since the new leasing model is based on control (rather than the prescriptive and form-driven standards today), we expect there will be fewer instances of the lessee being the accounting owner of the construction asset. This will lead to fewer build-to-suit leases being evaluated under the sale-leaseback rules. However, since virtually all leases will result in recognition of a right-of-use asset and liability once the lease commences, the off-balance sheet benefit during the construction period will be lost once the lease begins.
Example 6 – Build-to-suit – lessee does not obtain control of construction-in-process (real estate)

**Facts:** Insurance Corp enters into an arrangement with Developer Corp to lease a building that will be used as office space for ten years contingent on Developer Corp completing construction of the building in accordance with the construction plan. Developer Corp holds legal title to the land on which the building will be constructed as well as legal title to the building under construction. Developer Corp does not have an enforceable right to payment for its performance to date if the arrangement terminates prior to completion of construction. The useful life of the asset is 40 years. Insurance Corp is obligated to reimburse Developer Corp for any construction cost overruns from the inception date of the arrangement to the completion date of the construction project. During the construction period, Insurance Corp has access to the building in order to inspect the progress of the construction and to make its own tenant improvements. Insurance Corp does not have the right to buy the partially constructed building at any point during the construction period.

Insurance Corp reimburses Developer Corp for $300,000 due to unexpected cost overruns during the construction period. In addition, Insurance Corp incurs $200,000 of additional construction costs related to discretionary tenant improvements, including branding elements.

**Question 1:** Does Insurance Corp control the underlying asset during the construction period?

**Discussion:** No. Insurance Corp does not control the building during the construction period.

Although Insurance Corp has access to the building, incurs costs related to customizing the space, and has financial risks (overruns) related to the construction of the asset, Insurance Corp does not obtain control of the building under construction before the lease commencement date (i.e., the construction completion date). Developer Corp does not have an enforceable right to payment for performance to date unless and until construction is completed. Insurance Corp does not have the right to buy the partially constructed building. In addition, none of the other indicators of control are present.

**Question 2:** How should Insurance Corp account for the costs incurred during the construction period?

**Discussion:** The $300,000 of construction cost overruns paid by Insurance Corp are lease payments because they relate to required costs incurred in connection with the completion of the leased asset and do not represent payment for a good or service provided to Insurance Corp. Accordingly, Insurance Corp should recognize such costs as prepaid rent. Insurance Corp should account for the $200,000 of construction costs incurred as lessee assets (i.e., leasehold improvements) that would be depreciated over the shorter of their useful lives or the lease term.
About PwC’s Insurance practice

The insurance industry faces challenging markets, new regulatory reform measures, and competition for clients and talent – all against a backdrop of heightened expectations from investors, regulators, industry partners, and other stakeholders. Our insurance partners and staff can assist in meeting these key industry challenges.

PwC helps organizations and individuals to create the value. We’re a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, tax, and advisory services.

For more information, please contact:

**Donald Doran**  
Partner  
Phone: 1-973-236-5280  
Email: donald.a.doran@pwc.com

**Lucy Lillycrop**  
Partner  
Phone: 1-973-236-4294  
Email: lucy.lillycrop@pwc.com

**Shintaro Sakamoto**  
Partner  
Phone: 1-646-471-4973  
Email: shintaro.sakamoto@pwc.com

**Cristina Ahn**  
Senior Manager  
Phone: 1-973-236-5112  
Email: cristina.e.ahn@pwc.com

© 2016 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. To access additional content on financial reporting issues, visit www.pwc.com/cfodirect, PwC’s online resource for financial executives.

Questions?
PwC clients who have questions about this In depth should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

**Authored by:**

**John Bishop**  
Partner  
Phone: 1-973-236-4420  
Email: john.bishop@pwc.com

**Chad Soares**  
Partner  
Phone: 1-973-236-4569  
Email: chad.c.soares@pwc.com

**Ashima Jain**  
Managing Director  
Phone: 1-408-817-5008  
Email: ashima.jain@pwc.com

**Matt Adams**  
Partner  
Phone: 1-646-471-8688  
Email: matt.adams@pwc.com

**Cristina Ahn**  
Senior Manager  
Phone: 1-973-236-5112  
Email: cristina.e.ahn@pwc.com

**Justin Frenzel**  
Senior Manager  
Phone: 1-973-236-4970  
Email: justin.w.frenzel@pwc.com